DEPARTMENT OF STATE REVENUE

02-20160408R.ODR

Final Order Denying Refund: 02-20160408R
Income Tax
For The Tax Year 2010

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Final Order Denying Refund.

HOLDING

Business did not provide sufficient documentation and analysis to support its claim for refund based on the Qualified Research Expense Tax Credit. Therefore, the Department's initial denial of refund was appropriate.

ISSUE

I. Income Tax–Research Credit.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-9-1; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014); U.S. v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Union Carbide Corp. and Subsidiaries v. Comm'r., T.C. Memo 2009-50, 2009 (2009); Wendt LLP v. Indiana Dept. of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); I.R.C. § 41.

Taxpayer protests the denial of a claimed refund of income tax.

STATEMENT OF FACTS

Taxpayer is a manufacturer in Indiana. In 2011, Taxpayer filed an amended Indiana income tax return claiming a refund of income taxes it paid for the tax year 2010. The claim was based on Taxpayer's listing of certain expenses as eligible for the Qualified Research Expense Tax Credit. The Indiana Department of Revenue ("Department") conducted a refund investigation and denied the claim for refund. The Department based its determination on the fact that it did not believe that Taxpayer provided sufficient documentation and analysis to establish that it met the statutory terms for claiming the credit. Taxpayer filed a protest of the denial. An administrative hearing was conducted and additional time was allowed for the submission of additional documentation and analysis. The deadline passed without the provision of additional documentation or analysis. This Final Order Denying Refund results. Further facts will be supplied as required.

I. Income Tax–Research Credit.

DISCUSSION

Taxpayer protests the denial of its claim for refund. Taxpayer states that its activities on four projects conducted during 2010 constituted research which qualified for the Qualified Research Expense Tax Credit ("Credit") and that its amended 2010 income tax return accurately claimed the Credit. The Department conducted a refund investigation of the amended return and determined that Taxpayer had not submitted sufficient documentation to establish that its activities did qualify for the credit.

The Department notes that, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . .[courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

IC § 6-8.1-9-1(a) states:

> If a person has paid more tax than the person determines is legally due for a particular taxable period, the person may file a claim for a refund with the department. Except as provided in subsections (f) and (g), in order to obtain the refund, the person must file the claim with the department within three (3) years after the latter of the following:

(1) The due date of the return.
(2) The date of payment.

For purposes of this section, the due date for a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax is the end of the calendar year which contains the taxable period for which the return is filed. The claim must set forth the amount of the refund to which the person is entitled and the reasons that the person is entitled to the refund.

Taxpayer filed its claim for refund within the three year deadline imposed under IC § 6-8.1-9-1(a). Therefore, the issue to be determined is whether or not Taxpayer's activities qualified for the Credit and, if so, to what extent.

Taxpayer protests that the Department erred in denying the Credit for the years at issue. Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC 6-3.1 and IC 6-3.5. One of the tax credits available under Indiana tax law is the Indiana Qualified Research Expense Tax Credit under IC § 6-3.1-4-1 et seq. The 2003 statute, which was effective until December 31, 2015, and is relevant to the tax years at issue (the "2003 Indiana Statute"), provides:

> The provisions of Section 41 of the Internal Revenue Code **as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001**, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

IC § 6-3.1-4-4 (2003) (**emphasis added**).

Further, "qualified research expense" under the 2003 Indiana Statute is "as defined in Section 41(b) of the Internal Revenue Code as **in effect on January 1, 2001**[.]" IC § 6-3.1-4-1 (2003) (**emphasis added**). "Qualified research" is defined in the Internal Revenue Code ("I.R.C.") under section 41(d). I.R.C. § 41(d) defines qualified research in pertinent part as follows:

> Qualified research defined.-For purposes of this section-
> (1) In general.-The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information-
> (i) which is technological in nature, and-
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
> Such term does not include any activity described in paragraph (4).

(Emphasis added).

This provision sets out a four-pronged test for qualified research. First, the research must have qualified as a business deduction under § 174. § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. § 41(d)(1)(C). Since § 41(d)(1) uses the conjunction "and" between § 41(d)(1)(B) and § 41(d)(1)(C) rather than "or", all four prongs of the test must be met in order to qualify for the Credit.

In its amended return claiming a refund, Taxpayer calculated the amount of the Credit it believed due on four projects. In order to qualify for the Credit, Taxpayer must meet the four-part test listed above, provide documentation that it meets the test, and provide documentation that the amount of Credit claimed is directly linked to qualified research. The Department's refund investigation report analyzed Taxpayer's documentation under each step of the four-part test under the 2001 federal regulations and at times the 2004 regulations. Throughout the audit and protest process Taxpayer explained that it qualified for the Credit and provided documentation for its projects. Overall the Department determined that Taxpayer did not engage in activities which qualified for the Credit.

Regarding the level of documentation and analysis required from a taxpayer claiming the Credit, the Department refers to U.S. v. McFerrin, 570 F.3d 672 (5th Cir. 2009), which states in relevant part:

> The government next argues that even if qualified research occurred, McFerrin failed to provide adequate documentation to substantiate the costs associated with that research. But this goes against the longstanding rule of Cohan v. Commissioner that if a qualified expense occurred, the court should estimate the allowable tax credit. 39 F.2d at 544. If McFerrin can show activities that were "qualified research," then the court should estimate the expenses associated with those activities. The district court need not credit McFerrin's reconstruction of expenses from years after the fact. See Eustace v. Comm'r, 81 T.C.M. (CCH) 1370, *5 (2001). But the court should look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate.

Id. at 679.

The Department also refers to the United States Tax Court case Union Carbide Corp. and Subsidiaries v. Comm'r., T.C. Memo 2009-50, 2009 WL 605161 (2009). A relevant portion of the opinion provides:

> III. Claimed Costs
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> One of petitioner's expert witnesses, Wendi Hinojosa, was responsible for costing the claim projects. Ms. Hinojosa was qualified as an expert in the accounting systems and documentation used by UCC in the credit years and the base period. Petitioner claims as QREs incurred by UCC in connection with the claim projects $23,356,600 for 1994 and $32,114,800 for 1995.
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> A. Cost Documentation Used
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> 1. PCDs and MASs
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> The primary cost accounting records that Ms. Hinojosa used to calculate the cost of the supplies used in the claim projects were PCDs and material accounting summary reports (MASs). PCDs and MASs were part of UCC's material accounting system used to track variable costs (costs that vary with production) such as raw materials, catalysts, and other materials used in the manufacturing process. UCC used the material accounting system during both the credit years and the base period. There were no significant differences in UCC's material accounting system and related documentation during these two timeframes.
>
> The PCD was UCC's official cost accounting record for products that it manufactured. PCDs contained detailed cost information for every product that UCC manufactured, including the materials and quantities used in production. PCDs were produced monthly and annually, not for particular projects. The PCD for any given year consisted of approximately 3,000 pages.
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> MASs are inventory control reports containing a transaction summary for every material UCC manufactured or purchased, each of which was assigned a unique product code. Material production and consumption information was contained in both PCDs and MASs. However, PCDs were organized by manufactured product, whereas MASs were organized in numerical order by product code and listed all transactions for each product code by location.
> Id. at *42-3.

The Union Carbide court also provided:

> The research credits claimed on petitioner's original returns and allowed by respondent included the wages of UCC's R & D scientists and engineers at its technical centers. Petitioner now seeks to treat as additional QREs amounts paid to operators at Taft and Star for the Amoco anticoking and UCAT-J projects, respectively.
>
> For the Amoco anticoking project, petitioner treated as wage QREs the wages paid to Mr. Hyde, Mr. Tregre, and Mr. Gorenflo according to the number of hours each spent working on the project. Mr. Hyde and Mr. Tregre both credibly testified that they spent a combined total of 50 hours working on the Amoco anticoking project. We find that the services that Mr. Hyde and Mr. Tregre provided in connection with the Amoco anticoking project, including planning the tests, participating in the pretreatments, and sending the data to the technical center to be analyzed, constitute qualified services. While respondent argues that petitioner has not substantiated its claimed QREs, we find that the testimonies of Mr. Hyde, Mr. Tregre, and Ms. Hinojosa were credible and sufficiently substantiated the wages paid to these employees. We find that petitioner has

> satisfied its burden and may treat as wage QREs $835 and $210 for 1994 and 1995, respectively. However, Mr. Gorenflo did not testify as to how much time, if any, he spent on the Amoco anticoking project. Accordingly, petitioner has not satisfied its burden of proving that Mr. Gorenflo spent 2 hours engaged in qualified research with respect to the Amoco anticoking project in 1994 and may not claim his wages as QREs.
> . . . .
> Id. at *115. (Emphasis added).

These cases establish the level of supporting documentation and analysis which are acceptable in applying for the Credit. The Department notes that the McFerrin decision was issued by the Fifth Circuit Court of Appeals, while Indiana is located in the Seventh Circuit. The McFerrin opinion is therefore not binding on Indiana. However, the Department finds the McFerrin opinion illuminating. The McFerrin opinion states that, if the taxpayer in that case could show activities that were "qualified research," then the court should estimate the expenses associated with those activities. Specifically, the court explained that it should look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate.

The Department notes that, other than Taxpayer's basic statement of its claim, with generalized references to various statutes and court cases, there is no testimony or other evidence supporting Taxpayer's claim. There is no "testimony," since no one was under oath or penalties of perjury. There is no documentation available. As the Union Carbide court explained, the employees themselves testified as to the actual hours they worked on projects which qualified for the R&D credit. In the instant case, no such analysis was provided. In light of the lack of documentation and/or analysis, Taxpayer has not presented a sufficiently developed argument for the Department to address. See Wendt LLP v. Indiana Dept. of State Revenue, 977 N.E.2d 480, 485 n.9, (Ind. Tax Ct. 2012) (stating in a footnote parenthetical "that poorly developed and non-cogent arguments are subject to waiver" by the Indiana Tax Court) (citing Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax. Ct. 2010)).

Therefore, a taxpayer claiming the Credit is able to use a wide range of documentation and expert testimony to support its claim, as provided by Union Carbide. In this case, however, virtually no documentation or expert analysis has been provided. Taxpayer has merely made the assertion that its activities qualify for the Credit under § 41(d)(1). As provided by Wendt, this is not a sufficiently developed argument for the Department to address. Taxpayer has not established that it qualifies for the Credit found under IC § 6-3.1-4-4 (2003).

FINDING

Taxpayer's protest is denied.

Posted: 05/31/2017 by Legislative Services Agency
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